Supreme Court, U.S.
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No. 03-907

In The

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

The statement of the question presented by the Commissioner of Internal Revenue is too broad to be helpful in this proceeding.

Most precisely stated, the question presented is as follows:

> Whether Oregon law provides a vested interest in the contingent fee for a contingent fee lawyer in Oregon cases from the beginning of the lawyer's participation in the case so that when the lawyer is paid his or her contingent fee directly by the defendant at the end of the case, that same fee is not subject to the so-called assignment of income doctrine, because the plaintiff-taxpayer did not own or assign the lawyer's direct recovery from the defendant and, thus, the lawyer's fee collected from the defendant is not part of the plaintiff-taxpayer's gross income under 26 USC § 61 for federal income tax purposes.

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STATEMENT OF THE CASE

The commissioner's statement of the case in his petition for writ of certiorari has two defects: (i) there is a serious misstatement of fact; and (ii) the commissioner ends the story too soon leaving out the most important parts.

The serious misstatement of fact occurs on page 6 of the petition. The commissioner states that Mr. Banaitis did not include any part of the settlement amount of $8,728,559 on his 1995 federal income tax return. Trial exhibit 2 (1995 federal income tax return of Sigitas J. Banaitis) shows that of the portion of the settlement that Mr. Banaitis received, he reported on line 8a $1,427,397 and that he paid $567,735 in federal income tax. That same federal income tax return had attached to it a detailed disclosure statement (form 8275) which explained the entire history of the case to the Internal Revenue Service and which provided figures for all the settlement amounts, including the $2,734,947 in legal fees paid *by the defendant* to the lawyer, Mr. Merten, together with $1,129,064 in interest paid *by the defendant* to Mr. Merten.

The disclosure statement attached to Mr. Banaitis' federal income tax return stated that the amounts paid by the defendant directly to the lawyer, Mr. Merten, were as a result of a novation which, as part of a litigation settlement agreement, and under Oregon law, became a direct obligation of the defendant to pay the plaintiff's contingent legal fees. The disclosure statement cited the pertinent Oregon law on this specific point which is *Eagle Industries, Inc. v. Thompson*, 321 OR 398, 900 P.2d 475 (1995).

Accordingly, the commissioner's statement that this transaction was not reported on the tax return is both misleading and incorrect.

The second defect in the commissioner's statement of the case is that the commissioner stops the story before getting to the most important part involving the payment of these contingent legal fees. This was a case in which Mr. Banaitis, as an executive officer of Bank of California, was fired by Mitsubishi Bank, the parent company, because Mr. Banaitis refused to disclose confidential loan customer information to Mitsubishi Bank for its use in competition with the Bank of California's loan customers. After a hard fought battle involving a jury trial, two appeals within the Oregon court appeals system, and a threatened petition for writ of certiorari to this court, the case was settled. But following is the most important part as it relates to the exclusion of the legal fees paid by one of the defendants directly to the lawyer, Mr. Merten, under the contract novation embodied in the settlement agreement.

On November 19, 1989, Mr. Banaitis entered into a contingent fee agreement with Charles Merten and Merten and Associates under which Mr. Banaitis retained Charles Merten and his law firm to pursue a potential lawsuit against Bank of California and Mitsubishi Bank, Ltd. (Stip. ¶ 8; Ex. 3-J). Mr. Banaitis considered his relationship with Charles Merten to be a partnership. (Tr. 98-99). Mr. Banaitis described the relationship as a "common battle" where the awards, if any, were to be shared. (Tr. 99).

Charles Merten has a history of accepting and litigating difficult cases. (Tr. 54). When Mr. Merten first reviewed Mr. Banaitis' case, he viewed the chance of success

as zero. (Tr. 55). Mr. Merten advised Mr. Banaitis that even in the best circumstances, 25 percent of cases that should be won are lost. (Tr. 56-57). Mr. Merten advised Mr. Banaitis that in his case, he could not expect more than a five to ten percent chance of winning. (Tr. 57). In paragraph 8 of the agreement, the parties recognized the uncertainty of the claim. (Ex. 3-J). Prior to trial, the defendants' maximum settlement offer was $60,000. (Tr. 64).

Under the fee agreement dated November 19, 1989, Mr. Merten was entitled to one-third of any recovery if the case was settled prior to the start of a trial and 40 percent of any recovery once a trial had started. (Ex. 3-J; Tr. 59-60). Mr. Merten was entitled to his percentage share even if Mr. Banaitis terminated him just prior to a settlement or just prior to a verdict. (Tr. 76, 78). Mr. Banaitis could not terminate the arrangement to avoid paying Mr. Merten his share. (Tr. 61). If Mr. Banaitis terminated Mr. Merten because they disagreed over accepting a settlement offer, Mr. Merten would be entitled, under Oregon law and practice, to a percentage of the offer he advocated accepting. (Tr. 76-77).

At the time of the jury verdict, Mr. Merten's right to 40 percent of any eventual recovery was fully vested. (Tr. 78-79).

On July 22, 1991, Mr. Banaitis and Charles Merten entered into a supplemental agreement to address legal fees incurred upon appeal. (Ex. 8-J). The supplemental agreement entitled Mr. Merten to an additional 2.9 percent of all punitive damages awarded and an additional 10 percent of all compensatory damages awarded. (Exs. 8-J, 25-J). These amounts were in addition to amounts to

which Mr. Merten was already entitled under the fee agreement dated November 19, 1989. (*Id.*)

Under the agreements, Charles Merten had the following additional rights:

(a) the ability to control the litigation (Tr. 60);

(b) the right to hire experts, other lawyers, and other professionals (Exs. 3-J (paragraph 9), 8-J; Tr. 61); and

(c) possessory lien rights and a statutory lien on a recovery (Tr. 61).

Mr. Merten was obligated to contribute to any costs of collection in proportion to his rights in any recovery. (Ex. 8-J (p.5-6)). Mr. Merten was obligated to compensate lawyers hired by him in his discretion to handle the appeal. (Ex. 8-J (p.6)).

On October 26, 1995, Bank of California, Mitsubishi Bank, Charles Merten, and Mr. Banaitis agreed to a cash settlement to be paid to Charles Merten and Mr. Banaitis in exchange for dismissing or satisfying the lawsuit for the tort claims against the banks. (Stip. 17; Ex. 10-J). As part of the settlement agreement, Bank of California made payment of $3,864,012 by separate check directly to Charles Merten. (Stip. 17; Ex. 12-J). This payment represented Charles Merten's share of the partnership-type arrangement he and Mr. Banaitis had. (Tr. 110). Mr. Banaitis never had any control over the funds paid to Charles Merten. (Tr. 104). As part of the settlement agreement, Mitsubishi Bank, Ltd., paid Mr. Banaitis $4,864,547. (Ex. 11-J).

The banks' main motivation in settling the case was so the litigation would not hold up the federal regulators' review of a proposed merger. (Tr. 70-71).

On March 7, 1996, Charles Merten wrote a letter to the attorney general of the state of Oregon, reporting to the attorney general that Mr. Banaitis had been involved in an action involving personal and bodily injury against the Bank of California and Mitsubishi Bank, Ltd. (Ex. 22-J). Mr. Merten asserted that the punitive damages splitting statute, ORS 18.540, did not apply to Mr. Banaitis, or, in the alternative, that ORS 18.540 violated various constitutional provisions. (Ex. 22-J). The attorney general's office demanded 60 percent of the punitive damages awarded and, as a fall back position, 50 percent of the punitive damages awarded. (Tr. 68). Mr. Banaitis eventually settled with the state of Oregon regarding its claim for a portion of the punitive damages. (Tr. 111).

From his portion of the settlement, $4,864,547, Mr. Banaitis has paid state and federal taxes on the interest portion in the amount of $679,624, settlement with the state of Oregon in the amount of $150,000, and legal fees relative to the state of Oregon claim and tax claims in the amount of $117,578. (Ex. 26). The Internal Revenue Service is demanding tax in the amount of $1,708,216, and the state of Oregon is demanding tax in the amount of $195,051. (Exs. 1-J, 26). If these taxes are paid, Mr. Banaitis would be left with a net recovery of $1,984,078. (Ex. 26). Part of the tax demanded by the Internal Revenue Service and the state of Oregon is related to the funds received directly by Charles Merten. (Ex. 1-J). Out of a total settlement of $8,728,559, for both Mr. Banaitis and the lawyer, if all asserted taxes are paid, Mr. Banaitis will be left with $1,984,078, 22.7 percent of the total settlement. (Ex.

26). If the state of Oregon had been paid the total amount of punitive damages it had demanded, Mr. Banaitis would have been left with nothing. (Tr. 111).

The novation agreement among Mr. Banaitis, his lawyer Mr. Merten, and the two defendant banks is exhibit 10 in the trial record. Exhibit 10 is a novation under *Eagle Industries, Inc. v. Thompson*, 321 OR 398, 900 P.2d 475 (1995), because the contingent fee arrangement between Mr. Merten and his client, Mr. Banaitis, was terminated and because the obligation to pay the fees was assumed by the defendant banks. The novation in this case gave the lawyer, Charles Merten, an independent right against the defendants in the underlying suit. The settlement agreement and mutual release (exhibit 10) states:

1. the lawyer has an independent right to receive his payment directly from the defendants;

2. Bank of California, N.A., will pay the lawyer his fee directly with a separate check;

3. the lawyer, Charles Merten, was required to acknowledge satisfaction of his part of the case;

4. the lawyer independently promised to keep the confidentiality of the agreement;

5. the lawyer was required to sign the agreement "Charles J. Merten, *personally* and as attorney for Sigitas J. Banaitis."

There is no doubt under Oregon law that if the banks had failed to pay Mr. Merten, as agreed, that he would have had a direct cause of action against the banks based on the novation. *Potter v. Schlesser, Co.*, 335 OR 209, 63

P.3d 1172 (2003) (plaintiff's contingent fee lawyer has direct cause of action under Oregon law against defendants who settle a claim without paying the contingent legal fee.)

REASONS FOR DENYING THE COMMISSIONER'S PETITION

The petition should be denied because this is essentially a state law case: the decisions of this Court require initial reference to state law; the decisions of most of the federal courts of appeals require initial reference to state law; and the Federal Rules of Decision Act requires initial reference to state law.

1. The decisions of the Supreme Court require that state law determine, first, the incidents of ownership of income, and then federal law determines how those incidents of ownership are to be taxed.

The provisions of 26 USC § 61 state that a taxpayer's gross income for federal income tax purposes includes "all income from whatever source derived." But, there is no federal law of contracts and there is no federal law of property to tell us, as a matter of federal law, what income belongs to which taxpayer. This Court has repeatedly and definitively held that the incidents of ownership of an item of income are determined under the applicable state law and *only then* is the federal income tax law applied to determine the tax amount as imposed by Congress.

Poe v. Seaborn, 282 US 101, 75 L.Ed. 239 (1930). Mr. and Mrs. Seaborn lived in the community property state of

Washington. Each reported one-half of *Mr. Seaborn's* working income on an individual federal income tax return. The commissioner, using the same arguments he is using in this case, charged that the Seaborn's method of reporting was an illegal assignment of Mr. Seaborn's working income and, under *Lucas v. Earl*, 281 US 111 (1930), was prohibited. This Court held that the word *income* in the federal tax statute is not defined for federal purposes and that the bundle of economic rights to determine whose income a particular item is must be determined by the applicable state law. That is the law today, and the commissioner would not dream of coming to this Court or any court and arguing that the application of the local community property law was some how offensive to the dignity of the federal taxing statutes.

Morgan v. Commissioner, 309 US 78, 84 L.Ed. 585 (1940). This court held: "State law creates legal interests and rights. The federal revenue acts designate what interests or rights so created shall be taxed." 309 US at 80.

Drye v. United States, 528 US 49, 145 L.Ed.2d 466 (1999). This was a federal tax lien case in which Justice Ginsburg began her opinion by stating: "This case concerns the respective provences of state and federal law in determining what is property for purposes of federal tax lien legislation." Justice Ginsburg explained that under the law of Arkansas, that applied in that case, the taxpayer, Mr. Rohn Drye, acquired an immediate property interest in his mother's assets on the date of her death, to which a federal tax lien attached. Mr. Drye's later attempt to destroy the federal tax lien by disclaiming the inheritance was ineffective for federal tax purposes because the federal tax lien had already attached to his bundle of rights acquired under Arkansas law.

United States v. Craft, 535 US 274, 152 L.Ed.2d 437 (2002). Justice O'Connor, writing for the Court, explained that the federal tax lien attached to the bundle of rights held by the husband in that case under Michigan law and held that, after determining that the tax lien attached to the husband's state law bundle of rights, the federal tax lien cannot be displaced by elements of state law that would attempt to disengage the federal tax lien after it had attached to the husband's property.

2. Almost all federal courts of appeals apply state law in contingent legal fee cases to determine the ownership interests as between the two contracting parties, the taxpayer-plaintiff and the contingent fee lawyer.

Almost all federal courts of appeals apply state law in contingent legal fee cases to determine the ownership interests as between the two contracting parties, the taxpayer-plaintiff and the contingent fee lawyer.

Three circuit courts of appeals have ignored the reality of the necessity of consulting the state law first and have tried to decide this type of case based on the abstractions of the federal tax law itself. *Hukkanen-Campbell v. Commissioner*, 274 F.3d 312 (10th Cir. 2001); *Young v. Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Banks v. Commissioner*, Dkt. Nos. 01-2171, 01-2177 (6th Cir. 2003).

However, all of the other circuits recognize that the attempt to decide ownership questions in a federal vacuum is fruitless, and that state law must provide the law of decision as to incidents of ownership upon which the federal law can then be applied.

Case Name and Citation	Controlling State Law	Decision for Taxpayer/ Government
Banaitis v. Commissioner, 340 F.3d 1074, 92 AFTR2d 5834 (9th Cir. 2003)	Oregon	Decision for Taxpayer
Cotnam v. Commissioner, 363 F.2d 119, 3 AFTR2d 527 (5th Cir. 1959)	Alabama	Decision for Taxpayer
Foster v. United States, 249 F.3d 1275, 87 AFTR2d 2001-2011 (11th Cir. 2001)	Alabama	Decision for Taxpayer
Estate of Mae Barlow Davis v. Commissioner, 210 F.3d 1346, 85 AFTR2d 1567 (11th Cir. 2000)	Alabama	Decision for Taxpayer
Srivastrava v. Commissioner, 220 F.3d 365, 86 AFTR2d 5410 (5th Cir. 2000)	Texas	Decision for Taxpayer
Estate of Arthur L. Clarks v. United States, 202 F.3d 854 85 AFTR2d 405 (6th Cir. 2000)	Michigan	Decision for Taxpayer

Case Name and Citation	Controlling State Law	Decision for Taxpayer/ Government
O'Brien v. Commissioner, 391 F.2d 531, 12 AFTR2d 5318 (3rd Cir. 1963)	Pennsylvania	Decision for Government
Baylin v. United States, 43 F.3d 1451, 75 AFTR2d 383 (Fed. Cir. 1995)	Maryland	Decision for Government
Coady v. Commissioner, 213 F.3d 1187, 85 AFTR2d 2049 (9th Cir. 2000)	Alaska	Decision for Government
Benci-Woodward v. Commissioner, 219 F.3d 491, 86 AFTR2d 5403 (9th Cir. 2000)	California	Decision for Government

Accordingly, there is no reason to grant this petition because both the decisions of the Supreme Court of the United States and the decisions of almost all of the circuit courts make clear that the application of state law is the only sensible approach to matters of determining underlying contract rights and property rights on which the federal tax law must operate. There is no new federal issue to decide in this case.

3. The Federal Rules of Decision Act (28 USC § 1652) requires that state law be applied to determine incidents of ownership in items eligible for taxation before the federal tax laws are applied to those incidents of ownership.

The provisions of 28 USC § 1652 are as follows:

> "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

The predecessor of that statute is section 34 of the Judiciary Act of 1789. In an early interpretation of the law in *Swift v. Tyson*, 16 Pet. 1, 10 L.Ed. 865 (1842), this court held that as to matters of commercial law and general jurisprudence, a uniform, federal common law would be developed to be applied by the courts of the United States. However, even under that attempt at federal uniformity, the laws of the individual states would still be applied in cases in which the states had a particularly strong policy interest, like the regulation of real property and the regulation of the relations between lawyer and client.

Accordingly, even under *Swift v. Tyson*, the existence of a lawyer's rights in a judgement in the form of a lien was to be considered a state law question. *Sun Life Assurance Company of Canada v. Casanova*, 260 Fed. 449 (1st Cir. 1919).

Of course, as all lawyers know, the attempt at creating a uniform federal common law proved to be a failure because it ignored the realities of the varieties of legal rights under the laws of the various states that defied uniformity, and because it ignored the deep and widespread existence of an already available body of pertinent law provided by the states of the Union. Accordingly, *Swift v. Tyson* was overruled in *Erie Railroad Co. v. Tompkins*, 304 US 64, 82 L.Ed. 1188 (1938).

Granting the government's petition in this case would further the government's attempt to return to the days of the failed attempt at a uniform federal common law that was disallowed in *Erie Railroad Co. v. Tompkins*.

CONCLUSION

The record in this case reveals that the jurors in the underlying state court action were hoodwinked and did not know that the federal Internal Revenue Service and the Oregon Department of Revenue were going to attempt to impose full taxes against Mr. Banaitis on the legal fee money that was the obligation of the defendants to pay directly to the lawyer, and which, if the governments' attempts had been successful, would have left Mr. Banaitis with very little of the judgement that the jurors intended to award to him. Only an application of Oregon law has provided the path to a correct and just result in this case.

Thus, the economic reality of the lawyer's ownership of his own legal fees from the beginning of the case was recognized by the United States Court of Appeals for the Ninth Circuit in the decision below. This is a parochial and narrow question of Oregon law. It is of no importance to the administration of the federal tax laws. A review of the matter is not deserving of this court's attention, and Mr. Banaitis respectfully requests that the government's petition be denied.

Respectfully submitted,

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